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Nos. 94-1119, 94-1120

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1994

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20TH CENTURY INSURANCE CO., *et al.*,
*Petitioners,*
v.
CHARLES QUACKENBUSH, Insurance Commissioner, *et al.*,
*Respondents.*

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CENTURY-NATIONAL INSURANCE CO., *et al.*,
*Petitioners,*
v.
CHARLES QUACKENBUSH, Insurance Commissioner of California, *et al.*,
*Respondents.*

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**On Petitions for Writs of Certiorari to the Supreme Court of California**

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## BRIEF OF RESPONDENT UNITED SERVICES AUTOMOBILE ASSOCIATION

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## QUESTION PRESENTED

Did the California Supreme Court err in concluding that a regulated entity is not entitled under the Fifth and Fourteenth Amendments to an opportunity to recover its cost of capital in the rates it is permitted to charge?

## PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT

Respondents United Services Automobile Association and its subsidiaries, USAA Casualty Insurance Company and USAA General Indemnity Company (hereinafter collectively "USAA") were respondents before the California Supreme Court and plaintiffs before the Superior Court for the County of Los Angeles in *Hartford Steam Boiler Inspection and Ins. Co. v. Garamendi*, No. BC 023983, which was consolidated in part with the actions brought by Petitioners 20th Century Insurance Company and 21st Century Casualty Company in the Superior Court, cases No. SFSC 938470 and No. BS 016289.

Respondent Charles Quackenbush is the Insurance Commissioner of California, substituted for his predecessor John Garamendi pursuant to S. Ct. Rule 35.3. Former Commissioner Garamendi was appellant before the California Supreme Court and defendant before the Superior Court. Respondent Voter Revolt intervened in the Superior Court and was an appellant before the California Supreme Court.

The other parties to these proceedings are listed at No. 94-1119 Pet. ii-iv and No. 94-1120 Pet. ii-iii.

United Services Automobile Association is the parent of, and wholly owns, USAA Casualty Insurance Company and USAA General Indemnity Company. While there are other wholly-owned subsidiaries of United Services Automobile Association, they are not involved in this proceeding, and there are no subsidiaries that are not wholly-owned.

TABLE OF CONTENTS


| | Page |
|---|---|
| QUESTION PRESENTED | i |
| PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT | ii |
| TABLE OF AUTHORITIES | iv |
| INTRODUCTION | 1 |
| REASONS FOR GRANTING THE WRIT | 3 |
| I. THE DECISION OF THE CALIFORNIA SUPREME COURT CONFLICTS WITH THIS COURT'S PRECEDENTS | 3 |
| II. CONFLICT AMONG COURTS REGARDING THE LEGAL STANDARD APPLICABLE TO WHETHER REGULATED RATES ARE CONFISCATORY HAS BECOME INTOLERABLE AS A RESULT OF THE DECISION BELOW | 5 |
| CONCLUSION | 6 |

## TABLE OF AUTHORITIES

*Cases* Page

*Appeal of Public Serv. Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269 (1988) ..... 5
*AT&T v. FCC*, 836 F.2d 1386 (D.C. Cir. 1988) ..... 5
*Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990) ..... 4, 5
*Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ..... 2, 3, 5
*Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276 (1923) ..... 3
*Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206 (D.C. Cir. 1991) ..... 5

*Constitutional Provisions*

U.S. Const. amend. V ..... 2, 6
U.S. Const. amend. XIV ..... 2, 6

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## BRIEF OF RESPONDENT UNITED SERVICES AUTOMOBILE ASSOCIATION

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### INTRODUCTION

United Services Automobile Association and its subsidiaries, USAA Casualty Insurance Company and USAA General Indemnity Company (hereinafter collectively "USAA") were parties before the California Supreme Court in the above-captioned proceeding, and accordingly are respondents under S. Ct. Rule 12.4 in case No. 94-1119 and case No. 94-1120 before this Court. USAA supports the position of the petitioners in these cases, and urges the Court to grant the petitions for certiorari.

USAA is a reciprocal inter-insurance exchange dedicated to serving the insurance needs of active and former military officers, employees of certain federal agencies, and their families. USAA has approximately 2.4 million members nationwide. Selling primarily homeowners and automobile insurance policies, USAA and its subsidiaries constitute the fourth-largest home insurer and fifth-largest private passenger automobile insurer in the United States.

At the outset, USAA notes that it has settled its Proposition 103 "rollback" refund obligation with the California Department of Insurance. USAA nonetheless urges the Court to grant the petitions and review the decision of the California Supreme Court, because the legal standard articulated and applied by the California Supreme Court below departs dramatically from the standard established by this Court in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), for determining when rate regulation goes too far and becomes a taking of private property without just compensation in violation of the Fifth and Fourteenth Amendments to the Constitution. The question of the appropriate legal standard governing that determination is of course a matter of great and continuing concern to USAA, as it is to any firm subject to ongoing rate regulation. The California Supreme Court's decision exacerbated a growing conflict among the lower courts over the proper understanding of this Court's opinion in *Hope*, a conflict that poses particular problems for insurers like USAA and other regulated entities that do business in different jurisdictions throughout the Nation. This Court should grant the petitions to resolve this conflict and ensure a uniform understanding of the federal constitutional limits on rate regulation throughout the United States.

## REASONS FOR GRANTING THE WRIT

### I. THE DECISION OF THE CALIFORNIA SUPREME COURT CONFLICTS WITH THIS COURT'S PRECEDENTS.

Although USAA has settled its particular "rollback" liability under Proposition 103, the legal standard announced by the California Supreme Court for deciding when rates are confiscatory has significance far beyond the particular factual context that gave rise to the decision below. That decision should be reviewed by this Court because the analysis and holding of the California Supreme Court plainly departed from the constitutional framework established by this Court.

This Court's opinions have long recognized the requirement that a regulated firm be allowed an opportunity to earn a return sufficient to cover its reasonable cost of capital. *See Hope*, 320 U.S. at 603; *Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 291 (1923) (opinion of Brandeis, J., joined by Holmes, J.). If a firm is not permitted to recover its cost of capital, the firm's capital is in effect being used by the public without payment, in violation of the takings clause. The fundamental error in the decision below is that the court divorced its understanding of a reasonable rate of return from the cost of capital.

This Court in *Hope* said that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks," 320 U.S. at 603—the common definition of the cost of capital. The California Supreme Court, however, transformed this standard of what the return "should be" under the Fourteenth Amendment into "an interest that the producer may pursue and not a right that it can demand." 94-1119 Pet. App. 79a; *see id.* at 84a, 85a-86a, 116a, 123a. Thus, the court converted what was a constitutional floor in *Hope* to merely an "interest" that can be balanced against other interests, so that what had been

understood to be a property right protected against uncompensated takings became simply a procedural right to a certain degree of consideration by the regulator.

In place of a return "commensurate with returns on investments in other enterprises having corresponding risks," the court below promised only protection against "deep financial hardship"—a standard not met so long as a firm can be said "to operate successfully," which the court below defined as meaning no more than covering "out-of-pocket" costs. *See* 94-1119 Pet. App. 79a-80a & n.18. Indeed, the California Supreme Court expressly noted its disagreement with the Ninth Circuit's decision in *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990), precisely because the *Gates* court held that a firm was entitled to recover more than its out-of-pocket costs. *See* 94-1119 Pet. App. 79a n.18.

The court below treated 20th Century's challenge to its rollback liability as a "test case." *Id.* at 34a. It disposed of that challenge by articulating a new constitutional standard that did not require affording the regulated firm the opportunity to recover its cost of capital, but instead required only that the firm not be driven into "deep financial hardship." 20th Century lost its case not because the California Supreme Court decided that the rates it was permitted to charge allowed it to recover its reasonable cost of capital, but because the court believed 20th Century could refund to policyholders what the Insurance Commissioner demanded without experiencing "deep financial hardship." The case was not decided on the basis of the particular facts of 20th Century's rate of return or cost of capital, but in light of the new legal standard articulated by the court below. The decision therefore has broad significance beyond the particular facts of 20th Century's situation, and cannot be limited to those facts. That is why USAA urges this Court to grant the petitions and review the new legal standard announced by the court below.

## II. CONFLICT AMONG COURTS REGARDING THE LEGAL STANDARD APPLICABLE TO WHETHER REGULATED RATES ARE CONFISCATORY HAS BECOME INTOLERABLE AS A RESULT OF THE DECISION BELOW.

Given the sharp departure of the court below from the standard established by this Court in *Hope*, it should come as no surprise that the ruling below conflicts with decisions of other state supreme courts and federal courts of appeals. Those courts have held in unambiguous terms that a regulated firm is entitled to an opportunity to earn a rate of return equal to its reasonable cost of capital. *See, e.g., Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990); *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206 (D.C. Cir. 1991); *AT&T v. FCC*, 836 F.2d 1386, 1389-90 (D.C. Cir. 1988); *Appeal of Public Serv. Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269 (1988).

Before the California Supreme Court, the Insurance Commissioner himself acknowledged that "it is not clear what showing is required to establish confiscation." Comm'r Opening Br. at 60. That uncertainty and confusion has been greatly exacerbated by the decision below. The resulting variety of "confiscation" standards affects multistate insurers and their policyholders due to inevitable cross-subsidies and other extraterritorial effects. For example, the military officers who, with their families, form the core of USAA's policyholders, move regularly among military bases in the United States and overseas. To serve them adequately, USAA must be able to provide insurance wherever these officers are assigned, including California. Yet it will be difficult to justify to non-California policyholders the continuation of California coverage if no return is permitted on the substantial capital at risk in California. Multistate insurers, including USAA, may be faced with a Hobson's choice between breaking relationships with policyholders while they are in California or weakening the security of all other policy-

holders by continuing to operate in California without a return on the capital at risk.

The question presented by the petitioners is an important one even for a party below like USAA that has settled its "rollback" refund, due to the application of the legal standard below to future regulation in California and the conflicting standards in states other than California. The question is also important for its obvious impact on regulated industries other than insurance. Those industries are subject to the same constitutional standard for confiscation under the Fifth and Fourteenth Amendments, and that standard ought to be uniform among the various states that regulate those industries.

## CONCLUSION

For the foregoing reasons this Court should grant the writ and reverse the decision below.

Respectfully submitted,

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